CONSIDERATIONS REGARDING TAX OPTIMIZATION IN IMPLANTED MULTINATIONAL ENTERPRISES THROUGH EXTERNAL GROWTH FOR THE AUTOMOBILE INDUSTRY IN CENTRAL-EASTERN EUROPE

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Abstract

The business strategy of multinational enterprises (MNEs) from the automobile industry implanted in Central-Eastern European (CEE) countries (Poland, Czech Republic and Romania) is an offensive one, global from operational perspective. Mainly it aims the extension of market share through horizontal growth, generally external type single-domain (Mergers and Acquisitions) and internal type (Greenfield investments) in a lower degree. These enterprises put in practice also a defending strategy for the owned market shares through increasing the efficiency of the production network at global level. This paper aims to present the less evident aspects of tax optimization of the applied business strategy by implemented MNEs in the automobile industry in CEE, and in this context, the necessity to establish transfer prices in accordance with the OECD recommendations, as an obligation assessed by the tax legislations of the considered countries, but also from the necessity of efficient run of these enterprises.

Keywords: *multinational enterprises (MNEs), external growth, transfer price, tax optimization.*

Introduction

Under the impulse of the economical and political changes in their business environment, MNEs put in practice operational strategies (of production, of markets and global) in order to maintain their competitiveness in accordance with the customers exigencies. The three categories of operational strategies, varying with the development level of the host state and implicit the advantages offered by localization, can be identified the dominant strategy. In interaction with this category of strategy, MNEs has applied to structural strategies (internal and external growth, strategic partnership), which modified their configuration, setting up the concentration of capital and production in a few regions on the world. These two strategies persuaded by the MNEs, defines jointly their business strategy (Nițu, 2003).

There are situations when the business strategy of the MNEs practiced on different markets, may assure a tax optimization. More exactly, MNEs implanted in foreign countries, on the way of external growth with the goal of the development of new activities, may benefit from the tax advantages, after transferring losses from the level of the over-token purchased firm on the profits of the parent firm. Also, in the case of a profitable subsidiary, the fusion with a local loss-making enterprise, can have the strategic goal of production capacity extension, and implicit, profit reduction of the new subsidiary (Mazerolle, 2006). In addition, the lack of harmonization of tax regulations on global level, permit the manipulation of transfer prices by MNEs for an optimal geographical profit distribution in order to decrease tax charges. However, the transfer price has to assure also an efficient allocation of the MNEs' inner resources and its administrative establishment on tax reasons, may generate efficiency losses, hard to identify. In this context, the drawn conclusion is that, the business strategy of the MNEs which invoke the approach of external growth for abroad implantation, may guarantee a tax optimization, in the conditions of the assignation of transfer prices according to the OECD recommendations in this field, and implicit the tax legislation of each host country, is the suggested solution, in order to assure the efficient run of these firms. A significant example can be the business strategy of MNEs from the automobile industry in the CEE countries (Poland, Czech Republic and Romania).

1.The role of the external growth in the business strategy of the MNEs from the automobile industry of some CEE countries

MNEs from the worldwide automobile industry (Volkswagen Group, Fiat, GM - Opel, Renault, Ford, etc.), which were implanted in CEE countries (Poland, Czech Republic and Romania) searched to obtain benefits through combining their own competitive advantages with the comparative advantages of the host countries, completed with the advantages of internalization. Beyond the favourable legal, economic and politic climate for implantations, the analyzed countries dispose of certain comparative advantages in the production of automobiles: the existence of an automobile industry (Skoda in Czech Republic; Fabrika Samochodow Malolitrazowych-FSM, Fabryka Samochodow Osobowy-FSO, Fabryka Samochodow Lublin-FSL in Poland; Dacia Piteşti, Automobile Craiova in Romania), of local subcontractors (Gumotex, Karsit, Jihostroj Velesin, Magneton, Motorpal, Cz Strakonice in Czech Republic; Kirchhoff Polska, Gedia Poland, HP Polska TI Poland in Poland; Caranda, Rombat Bistrița, Varta, Tudor, Ceproplast S.A. in Romania), and the main advantage is represented by the favourable proportion of cost-quality of workforce. In these conditions, the implantation in Central-Eastern Europe make possible for the multinational firms to benefit from low costs in the framework of a classical delocalization strategy based on the competitive price search. In this case, the result of the production rationalization strategy is a vertical type implantation. In addition, the international breakdown of the production process, specific to the automobile industry can offer an auxiliary explanation for this strategic logic.

The quasi-saturation of the western markets enforced the global carmakers to invest in CEE countries in order to conquer the internal market of the implantation places and the neighbour markets. This type of strategy is explained through the objective of transport costs minimization and the necessity of proximity to the clients. The extension of the market to CEE countries also allows the automobile MNEs to amortize the product development costs when their lifecycle are shortened. In addition, the local production offers a better adjustment to the local norms and information about competitors. In this case, the implantations are horizontal type and embrace the form of production or sale subsidiaries, specific to a commercial (market) strategy.

In the same time, automobile MNEs are engaged in global strategies, considering CEE countries straight an extension of the West-European markets. They establish, in this area, a productive network designated to supply local, European and global markets, in correspondence with the rationalization and industrial specialization scheme at continental level. The majority of the implantations realized by the carmakers are outcome of this type of strategy.

Therefore, the business strategy of the MNEs implanted in the CEE countries, is of offensive type, global from operational perspective, pursuing mainly the expansion of market shares through a mono-sector external type horizontal growth (e.g. VW purchase Skoda in Czech Republic; Fiat buy FSM in Poland; Renault acquire Dacia Piteşti in Romania etc.), and in a small compass internal type (GM-Opel realize a Greenfield investment in Poland). The defence of the already conquered market shares through the increased efficiency of the global production networks, in order to face the competition at global level, is also a strategic direction (Nițu, Bădescu, 2005).

The external growth of the MNEs, realized through mergers or acquisitions, generates a series of collective advantages and risks. Generally, the mergers and acquisitions are perceived as, at the level of developing countries analyzed as saviours for the local firms, potentially rewarding, but on the brink of crash (bankruptcy). However, the reorganization of the target firms may generate the decrease of work places, and implicit unemployment, the impact of these forms of growth for the host country are inauspicious from social point of view. Under the impact of competition, created by the take-over operations, the acquisition value of the target firm can increase against its real (stock exchange) value, which makes in time unsuccessful several similar activities. This aspect may be amplified by the technical, managerial and cultural problems generated by the take-over of the target firm, without being guaranteed a productivity growth at the level of the overtaken firm (Meier, Schier, 2005). Additional, must be mentioned the fact that, MNEs can obtain a tax optimization through the technique of external growth. More exactly, the tax advantages from which benefit the abroad implanted subsidiaries, through external growth, with the aim of developing new activities, targeting: the transfer of the subsidiary's losses upon the gains of the parent company, the possibility to deduce from its gross profits the interests due loans granted to the subsidiary, respective the appeal to mergers – acquisitions with a local deficient subsidiary, in the case of a subsidiary with surplus, in order to shrink the second's profits (Mazerolle, 2006). In this context, the lack of harmonization of tax regulations at global level permits a manipulation of the transfer prices, for an optimal geographical distribution of the profits, in order to diminish the tax charges, with negative effects on the efficiency of the MNE.

2. The OECD recommendations for methods to determine the transfer price and the analysis of regulations in this field in some CEE countries

The prices practiced in the transactions of goods and services proceeded between the subsidiaries of a MNE, called transfer prices, can be determined administratively, depending on the interests of the parent company and the involved subsidiaries. Multinational companies can constitute intra-group markets, where competition does not manifest. Therefore, the prices for the transactions practiced on these markets are not result of the reference between demand and supply, but the result of the will and the interests of these firms, which many times have to prove their correctness. At international level, the national legislations are different regarding the determination and evaluation of transfer prices. Additionally, the lack of tax regulation harmonization at global level tempts the MNEs to make appeal to the transfer price manipulation. In this case appears the risk of a double taxation, in the origin and host countries, and for the tax administrations from these countries difficulties in the verification of the correctitude in the determination of gross profits.

Based on these facts, OECD manifests a permanent interest in order to assure on global level a convergence regarding transfer price regulations. In this way, must be mentioned that the OECD recommendations are based on respecting the principle of perfect fair competition announced by OECD Model Tax Convention in art. 9(1), ground for bilateral tax conventions between member countries and other countries. Based on this principle, the applied transfer price between two subsidiaries of a MNE is just (fair), from the tax administrations point of view, if it is situated similar to the level of prices practiced by two independent enterprises, who deals with comparable transactions. Consequently, on one hand, the un-treatment of subsidiaries of a MNE as irresoluble units of a single unified group, but as distinct units, puts them on the plan of taxation as equals to the similar independent firms, in favour to the expansion of the international commerce and foreign direct investments. On other hand, in order to an alike comparison to be possible, there shouldn't be important differences between the compared situations, which influence the methodology of determining the price or the transactional profit, depending on the applied transfer price determination method. Otherwise, there are proposed reliable corrections, in order to eliminate the incidence of such differences. The OECD recommendations maintain a hierarchy in determination of the transfer pricing methods, estimating that the traditional transaction methods (comparable uncontrolled price method, cost plus method, resale price method) are the only ones which respect the principle of perfect fair competition. OECD recognizes that in some cases it is impossible to apply a pure transactional method. In this case the MNE can submit a profit based method, following the study of firms' profitability (transactional net margin method, comparable profit method, and profit split method) (OECD, 2001). Without denying its importance, OECD manifests its circumspection regarding the comparable profit method. The transfer price is only one component used in the determination of profit, being unfair adjusting the profit of a less performing MNE for the simple reason that it is not as profitable as one of its competitor. Because of this, OECD tends to uphold the method of consolidated profit split of the MNE between its subsidiaries, and also the method of net margin, recommending as last case methods.

Generally, in the case of EU countries, the regulations referring to transfer prices follow the recommendations of OECD regarding the determination methods and the prioritization in applying transactional methods (Table no.1).

Table no. 1
Methods of transfer price determination in EU countries

Countries	**Price comparison method**	**Cost plus method**	**Resale price method**	**Comparable profits method**	**Net margin method**	**Split profit method**
Austria	Yes	Yes	Yes	Yes	Yes	Yes
Belgium	Yes	Yes	Yes	Yes	Yes	Yes
Czech	Yes	Yes	Yes	No	No	Yes
Denmark	Yes	Yes	Yes	No	No	Yes
Switzerland	Yes	Yes	Yes	Yes	Yes	Yes
France	Yes	Yes	Yes	No	No	Yes
Germany	Yes	Yes	Yes	No	No	Yes
Italy	Yes	Yes	Yes	Yes	No	Yes
Great Britain	Yes	Yes	Yes	Yes	Yes	Yes
Poland	Yes	Yes	Yes	No	No	Yes
Portugal	Yes	Yes	Yes	Yes	Yes	Yes
Romania	Yes	Yes	Yes	No	No	Yes
Slovakia	Yes	Yes	Yes	Yes	Yes	Yes
Spain	Yes	Yes	Yes	No	No	Yes
Hungary	Yes	Yes	Yes	Yes	Yes	Yes

Source: after Ernst & Young, Transfer Pricing Global Reference Guide, www.ey.com, 2008; Taxation Code of Romania, Meteor Press, Bucharest, 2006.

As a rule, for the determination of the transactions market price, the tax administrations will use the method applied by the MNE, with the exception of the case in which the used method does not reflect the market price of the products and services, object of the transaction. In this case, the tax administrations will apply the most adequate alternative from the traditional transaction methods (comparable uncontrolled price method, cost plus method, resale price method) or any other methods recognized by the OECD directives regarding the transfer pricing (net margin method and split profit method), taking in consideration the circumstances individually for each and every case, respective the market conditions, contractual terms, special competitive conditions.

3. Scenarios regarding MNEs' tax optimization by external growth with applicability in the automobile industry in CEE countries. Effects of the manipulation of transfer prices.

Taking in consideration the business strategy of the implanted MNEs, with predilection on the way of external growth, in the automobile industry in Poland, Czech Republic and Romania, with the necessity of respecting the principle of perfect competition in the determination of transfer pricing, in accordance with the tax legislation in the mentioned countries, can be sketched out based on a simple, extremely general and hypothetic example, the possibilities of tax harmonization of these firms. Additionally, it is bought in discussion and analyzed the effect of transfer price manipulation, aiming the taxation, on the functioning efficiency of the MNE. The drawn conclusions from the further analysis come to complete the general aspects of the business strategy of the MNEs from investigated the automobile industry. The aim of the demarche is, on one hand, to emphasize aspects regarding taxation in their business strategy, and on other hand, to point out the fact that the reduction of the tax charges does not have to be the only goal of the MNEs in the moment when they determine transfer prices. Consequently, the determination of these prices in accordance with OECD recommendations becomes not only a limitation, induced by the tax legislation in the analyzed host countries, but also a necessity imposed by the efficient functioning of the MNE.

It is considered, thus, a MNE which produce and distribute, at the level of parent firm in the origin country, a product conventionally noted with X. The nominated cost function is $CT = 312.500 + 25Q + 0,0015Q^2$, where Q represents the production volume of the considered product X, the market price being p for the commercialized product established varying with demand and costs so that maximize the profit. In the conditions in which conventionally we consider as demand function $p= 100 – 0,0010Q$, where p represents the price of the considered product X, the profit reaches the maximal peak, when the marginal cost (C_{mg}) equals the marginal earnings (V_{mg}), which determines the sale price of 85 EURO/piece and an optimal quantity of 15.000 pieces ($C_{mg} = V_{mg}$; $25 + 0,0030 = 100 – 0,0020Q$; $Q = 15.000$ pieces; $p = 100 – 0,0010 \times 15.000 = 85$ EURO) *.

In the condition in which the considered MNE, from rational point of view of the production process, applies to the external growth, by acquisitioning from abroad a production subsidiary, this (year N) can register a deficit, thanks to the investments realized for technological modernization and R&D costs. In year N, the financial results of the MNE are presented in Table no. 2. At the level of the parent firm, the turnover is of 1.333.000 EURO, the costs are in sum of 1.098.000 EURO and the gross profit is 235.000 EURO. To notice is how the loss at the level of the implanted subsidiary on the way of external growth on a new market will diminish the gross profit of the MNE, which emphasizes the possibility of a tax optimization realized by the MNE in parallel with the practice of its business strategy.

Table no. 2

Financial results of the multinational enterprise with a shortfall subsidiary (year N)

- Thousands Euro -

Financial results of the parent firm			
Total costs	1.025	Turnover	1.275
Gross profit	**250**		
Total	1.275	Total	1.275
Financial results of the subsidiary in year N			
Total costs	73	Turnover	58
		Loss	**15**
Total	73	Total	73
Financial results of the multinational enterprise			
Total costs	1.025 + 73 = 1.098	Turnover	1.275 + 58 = 1.333
Gross profit	**250 – 15 = 235**		
Total	1.098 + 235 = 1.333	Total	1.333

After a few years (N+5), the shortfall subsidiary will become profitable, evidence of the succeeding business strategy of the MNE. In the current conditions, the cost function at the level of the foreign subsidiary is $CT_A = 100.000 + 20Q + 0,0010Q^2$, proving a cost reduction due to the strategy of rationalization for the production process pursued by the MNE. The cost function at the level of parent firm which assure, in the current situation, only the distribution of the X product produced by the subsidiary is $CT_B = 62.500 + 5Q + 0,0005Q^2$, and the demand function for product X is $p = 100 – 0,001Q$. Taking in consideration the fact that, the MNE will be efficient in the condition of resource allocation so that to maximize the consolidated profit, which, in this context, requires the determination of the price for product X at which this will be transferred between intra-firm from the level of the foreign subsidiary to the level of the parent firm. With other words, at the level of the MNE the transfer price and implicit the optimal quantity to be produced and transferred intra-firm, must be established in order to the marginal cost to equal the marginal revenue ($C_{mg} = V_{mg}$) at the level of the MNE.

In these conditions, the optimal quantity to be produced by the foreign subsidiary (Q) will be 15.000 pieces, the transfer to the parent firm for distribution at the price (p_t) of 50 EURO/piece ($C_{mg} = C_{mgA} + C_{mgb} = V_{mg}$; $C_{mgA} = V_{mg} – C_{mgB}$; $20 + 0,0020Q = (100 – 0,0020Q) – (5 + 0,0010Q)$; $Q = 15.000$ pieces; $C_{mA} = V_{mA}$; $p_t = 20 + 0,0020 \times 15.000 = 50$ EURO/piece). In these conditions, the financial results of the MNE are as follows: a turnover of 2.025.000 EURO (50 x 15.000 + 85 x 15.000 = 750.000 + 1.275.000 = 2.025.000 EURO), costs of 1.625.000

* The numeric example is adapted after F. Mazerolle, Les firmes multinationales, Vuibert Press, Paris, 2006, p. 235-243

EURO (100.000 + 20 x 15.000 + 0,0010 x 15.000 x 15.000 + 50 x 15.000 + 62.500 + 5 x 15.000 + 0,0005 x 15.000 x 15.000 = 625.000 + 750.000 + 250.000 = 625.000+1.000.000=1.625.000 EURO), and gross profit of 125.000 EURO (750.000 – 625.000 = 125.000 EURO).

In the conditions of a tax rate of 8% in the origin country of the MNE and of 34% in the host country, the consolidated net profit will be 296.500 EURO (275.000 – 275.000 x34% + 125.000 – 125.000 x 8% = 275.000 – 93.500 + 125.000 – 10.000 = 181.500 + 115.000 = 296.500 EURO), and the MNE could be tempted to manipulate the transfer price, in the sense of increase, in order to avoid from taxation a part of the profit of the foreign subsidiary (Table no. 3, Case I.).

If we take in consideration this last possibility, a raise of transfer price to 60 EURO/piece, will permit from perspective point of view, a reduction of the gross profit, in the condition of amplifying of the net profit, but the MNE will not assure the optimal resource allocation, registering a hardly identifiable loss at the level of efficiency (Table no. 2 and Table no.3). Must be mentioned that, if this loss is maintained, the tax advantages generated by the transfer price manipulation disappears as the consequence of the modification of the tax rate for the profit in the origin country, respectively the host country of the MNE.

Therefore, at the transfer price (p_t) of 60 EURO/piece, increases the produced quantity by the foreign subsidiary and delivered intra-firm of 20.000 pieces ($C_{mg} = C_{mgA} + C_{mgB} = V_{mg}$; $C_{mAg} = V_{mg} - C_{mgB}$; 20 + 0,0020Q = (100 – 0,0020Q) – (5 + 0,0010Q) + (60 - 50); Q = 20.000 pieces), and the transfer price of the product at the level of parent firm will be reduced to 80 EURO/piece (100 – 20.000 x 0,001 = 80 EURO/piece).

Table no. 3

Financial results of the MNE with a profitable subsidiary in the case of an optimal transfer price (I.) and in the case of an administratively increased transfer price (II) (both for year N+5)

Thousands Euro -

Case I.	**Case II.**	**Case I.**	**Case II.**
Financial results of the parent firm			
Total costs 1.000	1.562,5	Turnover 1.275	1.600
Gross profit 275	37,5		
Tax on profit 10	12,75		
Net profit 253	24,75		
Total (costs+ gross profit) 1.275	1.600	Total 1.275	1.800
Financial results of the subsidiary			
Total costs 625	900	Turnover 750	1.200
Gross profit 125	300		
Tax on profit 42,5	24		
Net profit 82,5	276		
Total (costs+ gross profit) 750	1.200	Total 750	1.200
Financial results of the MNE			
Total costs 1.000+625=1.625	1.562,5+900 =2.462,5	Turnover 1.275 + 750 = 2.025	1.600+1.200 = 2.800
Gross profit **275+125=400**	**37,5 + 300 = 337,5**		
Tax on profit 22+42,5=64,5	12,75 + 24 = 36,75		
Net profit **253+82,5=335,5**	**24,75 + 276 = 300,75**		
Total (costs+ gross profit) 1.625+400=2.025	2.462,5+337,5=2.800	Total 2.025	2.800

As result of the manipulation of transfer price, the MNE will register the following financial results: a turnover of 2.800.000 EURO (20.000 x 60 + 20.000 x 80 = 1.200.000 + 1.600.000 = 2.800.000 EURO), costs in sum of 2.462.500 EURO (100.000 + 20 x 20.000 + 0,0010 x 20.000 x 20.000 + 60 x 20.000 + 62.500 + 5 x 20.000 + 0,0005 x 20.000 x 20.000 = 900.000 + 1.200.000 + + 362.500 = 900.000 + 1.562.500 = 2.462.500 EURO) and a gross profit of 337.500 EURO (1.200.000 – 900.000 + 1.600.000 – 1.562.500 = 300.000 + 37.500 = 337.500 EURO). In the conditions of a tax rate of 8% in the origin country of the MNE and of 34% in the implantation country, the consolidated net profit will be 300.750 EURO (300.000 – 300.000 x 8% + 37.500 - 37.500 x 34% = 300.000 – 24.000 + 37.500 – 12.750 = 276.000 + 24.750 = 300.750 EURO) (Table no. 3, Case II).

In the considered hypothetic example, at establishing the level of its transfer price, the MNE had as objective the maximization of the consolidated profit. However, in reality, the principal logic followed is of reducing the tax contributions, the transfer price being established administratively, with negative effects on the efficiency of the rolled activities, at the level of the entire enterprise. It is to remark the fact that, in this context, the establishment of the transfer price with revere of the principle of complete competition, will eliminate this drawback. Taking as benchmark the market price for product X, the risk of inefficient operation of the MNE will decrease. The two independent firms, taken as benchmarks, will take as exogenous data the price established on the market and will determine the quantity of the delivered products in order to maximize their profits. Also, the MNE will comply with the tax stipulations of the implantation country regarding the determination and methods of transfer pricing, what will reduce the risk of penalty payments for tax administrations in the implantation country, where in the case the tax fraud determined by the transfer price manipulation would have been proved. The manipulation of the transfer price appears when the differences in the tax rates at the level of the considered countries are substantial; the registered net income can cover the loss of efficiency. In the case when the difference in taxation is reduced, the loss of the efficiency is maintained; the manipulation of the transfer price will lead to a decreased net profit.

In addition, in order to realize some kind of diminish of the profit in the implantation country and a cut for the tax contributions, the MNE can apply again to a tax optimization. Parallel with the strategic necessity to increase its production capacity, the enterprise can propose an external growth; the profitable subsidiary can merge with a local shortfall company from the same sphere of activity. If we consider for year N+5, the turnover for the subsidiary is in a value of 750.000 EURO and the total costs spent 625.000 EURO, the registered net profit will be of 125.000 EURO.

Table no. 4

Financial results of the new foreign subsidiary

Thousands Euro -

Financial results of the foreign subsidiary			
Total costs	625	Turnover	750
Gross profit	125		
Total	750	Total	750
Financial results of the shortfall firm			
Total costs	325	Turnover	200
		Loss	125
Total	325	Total	200
Financial results of the new foreign subsidiary			
Total costs	625 + 325 = 950	Turnover	750 + 200 = 950
Gross profit	**125 - 125 = 0**		
Total	750 + 325 = 950	Total	750 + 200 = 950

The firm acquisitioned by the MNE in order to fusion with the profitable subsidiary has a turnover of 200.000 EURO, total costs of 325.000 EURO, registering a loss of 125.000 EURO (Table no. 4). It is ascertained for simplification that the gross profit of the subsidiary is equal with the loss registered by the considered firm to realize the fusion. The MNE managed to assure a tax reduction on profit, but implicit a diminution of the equities value. This negative aspect is compensated by a capital gain owing to the raise of the shares value, and to be added also the success of the business strategy registered by the MNE.

Conclusions

The MNEs from the CEE automobile industry are applying with predilection to the external growth succeed, in the same time with the fulfilment of the strategic objective with economical and commercial facets, to realize also a tax optimization. On one hand, the tax objectives do not have to be the exclusive goal of a merger or acquisition operation, on other hand the taxation dimension of the business strategy on the MNE should not be neglected. Also, in the context of the followed business strategy for the MNE, the intra-group transfers must be realized at prices settled in harmony with the tax legislation from the implantation spaces, in accordance with the OECD recommendations. In the case of their manipulation, there wont be resource allocation in such manner that to guarantee a consolidated profit maximization at the level of the MNE. If the taxation discrepancy between countries is significant, thus the MNE to be tempted to manipulate the transfer pricing and to reduce the consolidated gross profit, the obtained tax gain can cover the loss of efficiency. In the case that, this disparity is reduced, the tax gain will not compensate the efficiency loss and the administratively determined transfer price will generate a reduced net profit.

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